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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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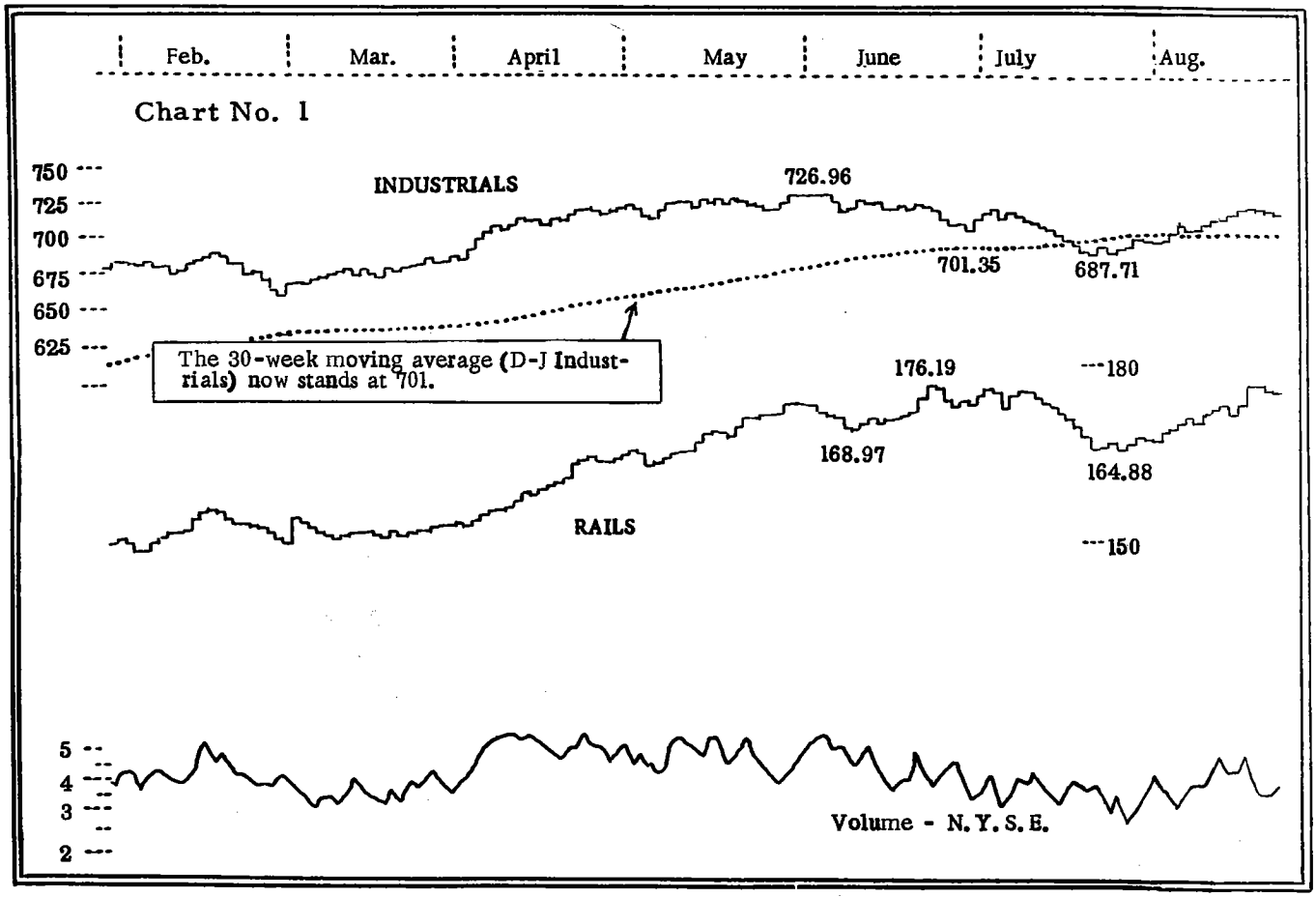
THE MARKET A group of knowledgeable investors were discussing the market at this office last week. "You know," said one, "there is an irony about the whole situation which one seldom encounters outside the world of the stock market. Since the 685.47 Industrial high of 1959, the bulls have been hoping for a mighty speculative 'blow-off' which might take Industrials to the 800 area on the Dow. By the same token, since 1959 the bears have been betting on a giant collapse on the order of 1929 or 1937.

"But the market has been unwilling to accomodate either school. In fact, since 1959 the market has risen above the 680 level on four separate occasions, and since 1959 the market has dropped below the 600 level on three different occasions. During each of those seven swings members of the opposing schools believed that 'their day had come'. Yet we're still waiting for the 'big one'. Many of us don't care which way it goes anymore — as long as the action is there -- and as long as there is a conclusion. If the market collapses, we'll have a return to great values and a true investment opportunity again. If the market 'blows its top' we'll have a chance to make some money in speculative issues and then to bail out of everything at fat prices. But give us a conclusion... a conclusion."

"The public" muttered a veteran broker from the back of the office, "if only the public would come back into this market we'd have our conclusion."

As far as this writer can see, the situation shapes up as follows: the technical "underpinnings" of the market are now quite strong -- strong enough to support a final "blow off" from this level. So far, however, the strong technical situation has not received its most important corroboration -- corroboration from the price movement itself. In other words, at certain times the background technical situation will allow for important movements in the market. But it is the actual unfolding of the price structure which tells us whether a given move is fated to occur.

As to the background technical picture, we should note that debit loans (i.e., the amount outstanding in N.Y.S.E. margin accounts) are currently at an all-time high. This phenomenon was discussed in a recent report, and briefly it means that professionals (margin



accounts tend to be held by professionals) are now betting on a substantially higher market. In the past a persistent expansion in N. Y. S. E. margin accounts has been associated with higher markets.

The total short interest remains well above the 5 million share mark, and this suggests that there is enough bearishness and skepticism to support a good rise.

The hope (and also the barrier) to an explosive rise from here continues to be the behavior of the public. Up to this point, the public has been unwilling to enter the market. Odd-lot volume as a percentage of total N. Y. S. E. volume remains at historically low levels (see Letter 227). Other measurements of speculative interest such as American Stock Exchange volume and the American advance-decline ratio confirm the view that the public is content to "stay at home". While this attitude persists, the market cannot become speculative. Yet great moves usually begin with public skepticism and terminate with public enthusiasm. We could be witnessing such a sequence now. There have been few times in history when the public was able to resist the spectacle of a steadily rising market. If the current advance persists, the public will (eventually) be tempted to climb aboard.

So much for the technical position of the market. "The cartridge is loaded with powder, and the trigger is cocked." It remains to be seen whether "the bullet will actually be fired."

From the standpoint of corroboration by the price movement, the situation is now intensely interesting. On August 16 the Rail Average rose above its May 31 recovery peak (above 176.19) to a new post-1956 high. Thus one half of a bullish signal has been given. However, the old Dow Theory dictum says: "One half of a signal is no better than none, and at times one half a signal can be deceptive." It is therefore imperative that Industrials confirm the new Rail high by rising to a new recovery high of their own -- above 726.96. If one wishes to be cautious one might now say that the longer the time period without an Industrial confirmation, the more potentially dangerous the situation.

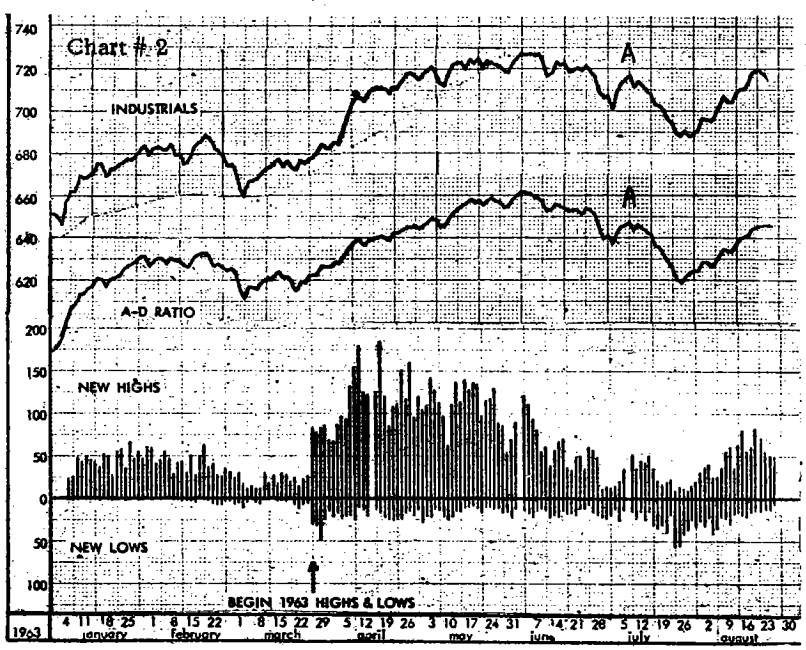
If Industrials better their 726.96 peak on increasing volume, the implications will be highly bullish -- and the Averages will be in line to extend their gains (probably to new highs). These highs are the 181.23 Rail peak of 1956 and the 734.91 Industrial peak of 1961. The joint hurdling of those highs could set the stage for the final "explosion" which has obsessed market bulls for over four years.

The other side of the coin is this: if Industrials refuse to confirm the Rails, and the two Averages turn down and violate their August reaction lows (those lows were 687.71 and 164.88), we will have received a primary bear signal. In that case the entire 1962-63 recovery movement will go down in the history books as an extraordinary secondary (upward) reaction (or, if you wish, as a "Baby" bull market).

It should be remembered that the current rise represents the fifth attempt by Industrials (since 1961) to plow through the 715-735 area. Each of the other rises (i.e., September, 1961; December, 1961; March, 1962; May, 1963) was followed by substantial declines or (in the March, 1962, instance) by a collapse. If the Industrial Average can now hurdle the 715-735 zone, it will have cut through a "supply zone" which has turned back the senior Average four times in the past two years. Such an accomplishment, if successful, would of course be highly bullish.

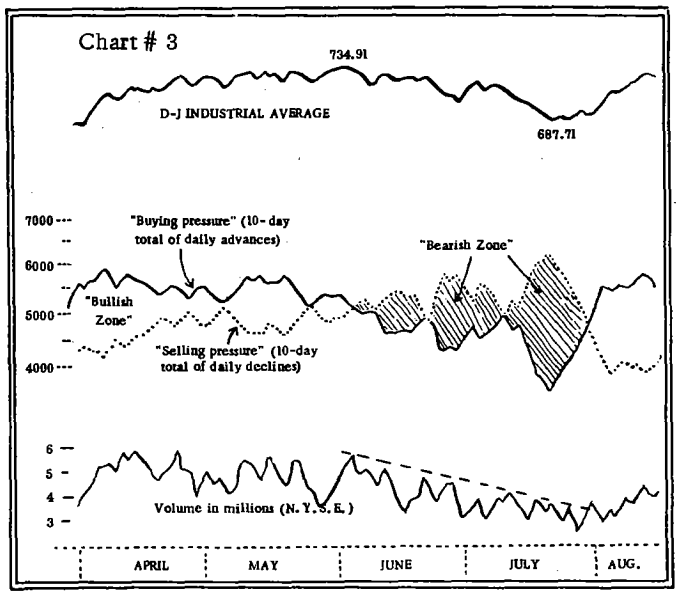
It is also of interest that as of August 1, 1963, only five stocks in the Industrial Average showed net gains over their 1961 peaks. These five stocks were General Motors, Chrysler, Standard Oil of Jersey, Standard of California and Texaco. In other words, a much smaller percentage of investment-grade issues are performing well on this rise than during the 1961 rise.

On a shorter term basis the accompanying chart #2 shows the path of the advance-decline ratio, the Industrial Average and the daily new highs and lows. As of this writing, the Industrial Average has bettered its July peak (A on chart) but the A-D ratio has not confirmed this movement. Daily new highs currently outnumber daily new lows, but new highs are lagging well behind their comparable March-April-May levels (at which time the Industrial Average was in this same area). The conclusion: if the market is to extend its rise from here, it will need more confirmatory evidence from the advance-decline ratio and daily new highs than is now evident.



BUYING AND SELLING PRESSURE (Chart #3) The buying pressure line crossed above selling on August 2. The two lines reached their farthest bullish spread on August 15, and since that time selling pressure has risen while buying has tended to diminish. There are two interesting rules connected with this study: (1) when

selling is dominant and the two lines reach extremes (i.e., selling line high, buying low), the market will usually begin to rally as soon as the two lines start coming together again. (2) When buying is dominant and the lines reach extremes (i.e., buying line high, selling low), the market will usually not go down until the selling line has actually crossed above buying.



As of now, it is probable that August 15 represented the height of buying pressure. However, unless there is an actual crossing (i.e., selling above buying) I would not expect any important downside action. In other words, the market can stay "overbought" but it usually will not stay "oversold" for any length of time.

SIXTY-SIX YEARS OF HISTORY Chart Number 5 (drawn to semi-logarithmic scale) traces the path of the D-J Industrial Average back through its entire history, a history covering sixty-six years. I have drawn three gradually ascending trendlines through the senior Average (trendlines A, B, and C). These trendlines represent the long-term growth factor or inflation amplitude. The trendlines describe an upward thrust within whose confines the Industrials have tended to move for the past three generations. Trendline A measures the upper limits of the growth factor, trendline C measures the lower limits and trendline B traces the average or mean growth factor.

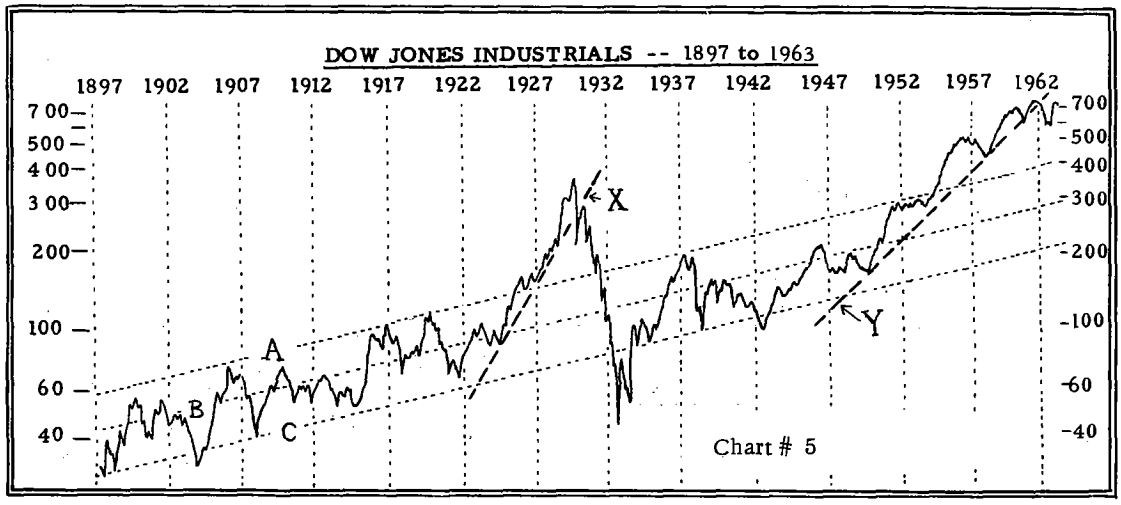
Only once during the first 55 years of D-J history did the Industrial Average move above the upper confines of its channel. This was during 1927 to 1929. That period represented the most intense era of speculation ever witnessed on the New York Stock Exchange. During the bear market that followed, the Industrial Average broke well below the lower channel limit for the first time. Thus it might be said that the 1929-32 bear market fully compensated for the excesses of the 1921-29 bull market.

Between 1934 and 1953 the Industrial Average again traveled within the confines of trendlines A and C. In 1954, for the second time since 1897, the Industrials rose above the upper limits of the channel. This action, based on past history, must be labeled as abnormal in that Industrials surpassed the upper limits of a "normal" growth pattern which has held intact for half a century.

As of this writing, Industrials have held in the "super-inflation" zone above trendline A for approximately 9 years as against the four years of 1929-31. Another comparison worth noting: when the major bull market trendline (marked X) was broken in 1929, the bear market correction began with a suddeness which shocked the citizens of "The Roaring Twenties". The main upward trendline (marked Y) traces the path of the bull market of 1949-61. In 1962 the twelve-year old trendline was shattered. Despite this event, fourteen months (and a "crash") have now passed into history, and the Averages are still in the upper reaches of the 1949-61 bull market area.

Thus two astounding periods of inflation and speculative intensity may be compared. Two long-term bull market trendlines (X and Y) have been broken. As one studies the situation, many of the old Wall Street adages come to mind: "History always repeats but never in exactly the same way". "The market always does what is is supposed to but never when it is supposed to". "What goes up comes down."

What will the outcome be? Will the inflationary boom which has been in existence since 1956 be fully corrected? How drastic will the correction be -- if it arrives? Will Industrials again go below trendline C (as in 1932)? Time alone will be the witness and the judge.



STOCKS Of 444 stocks tabulated weekly at this office, 302 or 68% are now holding above their 30-week moving averages (an improvement of 7% from last week).

As far as group relative strength is concerned, Aircraft continue outstandingly weak and these stocks (North American, Boeing, McDonnell) should be leaders on any downside move. Avco (in a closely allied field) also appears to have "topped out" and is in a position for shorting.

An outstanding turn to strength is now being exhibited by the mining and smelting stocks. The chart below shows the four-year downtrend in this group to a low in popularity which was touched in late 1962. This trend has now been reversed, and over the last few months this group's relative strength line has risen above the 1962 high. Stocks in the Mining & Smelting group which are worth speculating on are Mesabi Trust (a special situation with a tax-free feature), Calumet and Hecla and Newmont Mining (charts of all below).

Fairchild Camera has just reversed a long bearish trendline and has now pushed well above its 30-week moving average. The stock is an outstanding speculation. Chemtron is exhibiting excellent relative strength and is holding above its moving average. This stock is also a good speculation. Finally, a stock on the American which I have been watching with interest is Bearings. The stock is showing an excellent earnings trend, and it is picking up more and more volume as it rises. The rise has (so far) not been highly speculative. When a move becomes truly speculative, the stock usually pulls far away from its 10-week moving average (solid line on chart below).

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With Industrials failing so far to better their 726.96 high (thereby confirming the Rail high), the intermediate market trend is now unclear. This has made for a "hash" of cross currents in the market, with stocks showing every type of action and trend. The above buy suggestions are made for those who are willing to purchase with the stipulation that the stocks be sold in the event of a bear signal -- or for those who want stocks to buy in case Industrials better the 726.96 high. Any purchases might be hedged with a few shorts in the weak Aircraft group (this group acts so badly that North American Aviation -- on announcement of a 900 million NASA contract -- hardly broke its minor downtrend).

Small charts courtesy of Quote Digest, 110 North Lorraine, Wichita, Kansas.

Relative strength chart courtesy of Traders Research, Inc., 1431 Pearl Avenue, Alton, Illinois 62003